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a fifteen per cent reduction in the latter. In New York they have so far recognized the manufacturers' need of stabilized and dependable costs as to recede from their former attitude and negotiate shop and sectional production standards. We can expect much imperfection in the present stage of experience, but progress is being made.

Here and there manufacturing institutions, those that have passed out of the hands of their founders into those of the second generation, are feeling the need of something better than the di-

rect autocratic unsystematic management of the original proprietor, or even the mediocre systematic management that they have attained. With this in view, they have engaged management engineers to assist them onto a more scientific basis. At least five such concerns have made this move within the last two years. Although the men's and boys' ready-to-wear clothing industry has been and is still one of the worst and most wastefully managed industries in the United States, it is making progress out of that condition.

## Standards for Granting Credit

By J. H. TREGOE

Secretary-Treasurer National Association of Credit Men

**C**REDIT is the least understood of all the elements entering into commerce. Digging under the surface of American industrial history, one must recognize that credit illiteracy has largely been responsible for both hectic flushes and serious periodic depressions.

1837 was a year made distinctive by the second of our major panics. In that year 788 state banks with a capital of 290 millions were in operation. These banks had outstanding note issues of 149 millions and loans of 525 millions. Statistics of the mercantile credits that year are not available, but the over-extended condition of the banks was indicative of a prevailing speculation in real estate, internal improvements and business generally. There was apparently no thought for the future, and the bursting of the inflated credit bubble came, no doubt, as a surprise when it could have been clearly foreseen by the careful student. Credit illiteracy prevailed at that period and the violation of fundamental credit laws produced serious reactions and disorderly liquidation.

Moving forward two decades to 1857, a year marked by the third major panic in the nation's commerce, we find that 1,416 state banks with a capital of 371 millions and deposits of 231 millions were then in operation. The total sum of specie owned by these banks amounted to 58 millions. They had outstanding note issues of 215 millions and loans of 684 millions. Once again speculation was rife and fundamental laws were being attacked at every turn. Business was in a hectic flush and the complete unsoundness of the situation was demonstrated in a serious reaction and another disorderly liquidation.

Figures are perhaps unnecessary in a review of the major panics of 1873 and 1893. It is rather toward the peculiar psychology of the panic of 1893 that attention may be turned. That panic shows very clearly a certain attitude—that Americans have too frequently rated the acquisition of things as superior to the making of standards. Removing the surface sod in an investigation of credit history, we find con-

stantly alongside the wonderful ambition of the American temperament and the tremendous powers of the nation to invent and to produce, an appalling absence of intelligent perception of the uses of credit.

Coming down to the present period, and dissolving the existing depression into its component parts, we find violations of every canon of the credit decalogue and a repetition of the extravagant and unwholesome ideas that brought interruptions to progress in former years of depression and panic. It is high time for business and financial pilots to get a clearer grasp of credit currents and to become better qualified to steer the ship of commerce through the rocks and shoals. Business men can well afford to take inventory of the events of the past few years so that from the lessons of experience may come a realization of the unbreakable connection between credit and commercial prosperity or depression.

#### WHAT CREDIT IS

The definitions of credit given by many of the economists define its purposes and utilities but not credit itself. Mr. Clay defines it as a means for financing production in anticipation of future demands.<sup>1</sup> Other definitions could be cited but most of them present merely purposes and utilities rather than an exact definition of what credit really is. Speaking simply, credit is the modern medium of exchange.

From the beginning of men's association with one another credit was used in some form or manner but not until after the Industrial Revolution did it become a commercialized system and play its full part in the development of modern commerce.

<sup>1</sup> *Economics for the General Reader*. It is not unusual for economists to define credit substantially as follows: Credit is a promise to pay, usually to pay money. [Ed.]

The original and elementary method of exchange termed "barter," and that medium of exchange called "money" were not sufficiently adaptable and could not influence or keep pace with a large and expanding commerce. Largely because of its flexibility, because it could contract and expand according to the requirements of commerce, credit proved itself to be the medium that would build up the internal and international commerce of the trading nations of the world. Credit is, therefore, the atmosphere of modern business. Without credit, business would wither and society resolve itself into conditions of centuries ago.

#### CREDIT ARISES OUT OF COMMERCIAL TRANSACTIONS

The simple definition of credit given above will help anyone to understand one of its primary and fundamental laws. *Credit is not of itself a value but is representative of value.* Credit cannot be manufactured out of thin air. Banks are often spoken of as manufacturing credit. This is a misconception, for credit arises from an underlying value and may be granted only as values are created. When the underlying value becomes too thin for the credit superstructure or is removed entirely, a dangerous situation is created and inflation arises that will result in an expensive liquidation if it is not handled and controlled with consummate skill. As commodities supporting credit are transferred through the various processes of production and distribution, from raw materials to consumer, there should be an extinguishment of credit with each transferral and a complete liquidation of the various credits that have attended the transferral processes when the commodity is finally consumed.

Analyzing carefully the statistics cited above for the years 1837 and

1857 as they relate to the capital, circulation and loans of the state banks operating during these years, we can clearly see that the primary law of "underlying value" was completely neglected and that the over-extended condition in these periods caused violent contractions that were necessary to bring the sum of existing credits within proper and safe boundaries. If such contractions are accomplished without disorders then a disturbance merely will have occurred, though it may bring serious costs to the business and banking interests. But if the contraction becomes violent, a panic ensues with all of the disorders attendant upon this aberration of the human mind.

#### CREDIT IS NOT CAPITAL

A second very important and fundamental law of credit is that *credit is not capital*. This is true whatever definition of capital may be used. Attempts to make credit do the work of capital are violations of this law and will exact always the penalties that attend the intentional or ignorant transgression of economic laws.

The present depression has been occasioned chiefly by a widespread and senseless attempt to make credit do the work of capital. Credit has a definite beginning and ending. Credit must liquidate. Wherever possible credit should be in a self-liquidating form. Instruments, therefore, assigning a definite date for the extinguishment of credit are more scientific and useful than ledger charges on which our principal commodity business is transacted. The past three years have witnessed a number of instances in the credit field where this law was directly violated, and, strange to say, these offenses were committed largely by men of affairs, looked to as leaders in commerce and finance. With our underlying wealth, a strict conformity

to the fundamental laws of credit would have saved much of the present depression and enabled us at least to have kept our feet on the ground. We should have been better informed and acted with greater wisdom and moderation.

An increase of distribution through an increase of prices and not an increase of units is a danger mark always and points out the arrival of the hour when retrenchment and not expansion should set in. All over the land there were flagrant instances of liquid credit converted into fixed assets and much too frequently these mistakes happened with the full knowledge and assistance of bankers. A business enterprise must always have a sufficient sum of liquid capital in the form of assets that may be readily converted for immediate or pressing needs. To provide for increased distribution and speculative buying, large portions of this liquid capital were converted into fixed assets, and furthermore, large portions of the available commercial credit within the powers of the banks to grant for emergency purposes were mopped up by the process and used for the extension of plants and for commodity commitments that have since proved unlucrative and unable to earn even simple interest on the investments. No natural law in the credit world must be more closely observed than this one, that credit is not capital, and that any attempt to make credit do the work of capital is an unpardonable offense which will exact its toll and produce nothing but disappointments and losses.

#### CREDIT AND COÖPERATION

Coöperation is another fundamental law of credit development. Commodities may be produced and offered in competition but credit defies this commercial process and will strongly resent anything but coöperative treatment.

Individual action was long the controlling note of our national commerce. Not until 1896 did the coöperative vision burst upon our people. In a quarter of a century the American people have amassed treble the wealth and many times the commercial powers that were built up in the previous century. Perfect faith must exist in the relations of creditors to one another and in the relations of creditors to debtors. Any underhand motive—the desire to save oneself at the expense of others—is a hindrance to credit development and will prove always an expensive and an unwise practice. Coöperation is a divine principle of human action and is wonderfully exemplified in the credit world. Subordinating one's ideas to the ideas of the community is a principle of great promise. In the handling of credit the unreserved interchange of experiences and the combination of action will save much waste and prove of substantial advantage to the nation's commercial progress.

Credit has its material and moral elements. The seller of commodities and the lender of money will ask himself consciously, or unconsciously, these two questions of the credit risk: "Is the buyer or borrower able to pay, and is he willing to pay?" A favorable response to these questions establishes confidence, and confidence is necessary for the extension of credit. A negative reply withdraws confidence. A partial or incomplete response to these questions creates serious problems for the credit grantor.

#### THE THREE C'S OF CREDIT

A measuring rod has long been designed for the credit risk. It is termed

the three C's of credit: Character, Capacity and Capital.<sup>2</sup> When the risk measures up to this rod in every detail, it is rated a perfect risk. This complete measurement, however, happens infrequently in the granting of credit and very much rests on the skill of the credit grantor to determine how nearly the risk complies with, or how far short it falls of this standard of measurement.

The American temperament runs easily to speculation, so there is too frequently the neglect of standards and the taking of mere gamblers' chances in the granting of credit. The annual bad debt waste and the annual sum of frozen credits—clogging as they do the free flow of this ally to our large commerce—drive home with great power and conviction the fact that credit is indeed the least understood of all the elements entering into commerce and that the defect must be corrected if we are to make proper uses of our resources and hold our deserved position in world affairs.

Standards of credit granting have always existed and should have been understood and conformed to in our commerce. A halting of commercial progress will prove a great blessing if it is the occasion for the study of underlying causes and principles of credit,—and if a knowledge of the truths about credit is woven into future commercial practices. It is no reflection on the nation's future and powers to urge that more time be given to the study of fundamentals and that the transaction of business be based not so much on mere chance as on sound and righteous credit standards.

<sup>2</sup> In the case of commercial banking a fourth "C," collateral, is usually included. [Ed.]